

## Message Text

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ACTION EA-10

INFO OCT-01 ISO-00 CIAE-00 DODE-00 PM-03 H-01 INR-05 L-02

NSAE-00 NSC-05 PA-01 RSC-01 PRS-01 SP-02 SS-15

USIA-06 AID-05 COME-00 EB-04 FRB-01 TRSE-00 XMB-02

OPIC-03 CIEP-01 LAB-01 SIL-01 OMB-01 AGR-05 IO-10

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P R 160550Z NOV 74

FM AMEMBASSY PHNOM PENH

TO SECSTATE WASHDC PRIORITY 8314

INFO AMEMBASSY TOKYO

C O N F I D E N T I A L SECTION 1 OF 2 PHNOM PENH 15335

E.O. 11652: GDS

TAGS: EFIN, EAID, CB

SUBJ: IMF DEBRIEFING ON KHMER ECONOMIC SITUATION

1. ON NOVEMBER 14, THE IMG TEAM, LET BY MR. PAUL CHABRIER, PRESENTED TO THE USAID DIRECTOR AND MEMBERS OF HIS ECONOMIC STAFF AN INFORMAL ORAL REPORT ON THEIR ONE-WEEK VISIT. THE TEAM DEPARTED NOVEMBER 15. A SUMMARY FOLLOWS.

2. MR. CHABRIER STATED THAT HE WAS MUCH MORE PESSIMISTIC ABOUT THE STATE OF THE ECONOMY THAN WHEN HE HAD FIRST ARRIVED. HE SINGLED OUT THE CURRENT BUDGETARY IMBALANCE AND LACK OF SOUND FISCAL MANAGEMENT PROCEDURES AS THE MOST URGENT AND SERIOUS PROBLEM AREA, AND POINTED TO THE IMPENDING FOREIGN DEBT BUILDUP AS THE MOST THREATENING FUTURE ONE. HE SAID THAT BASED ON HIS TALKS WITH MINISTRY AND BANK OFFICIALS, THERE DID NOT APPEAR TO BE ANY PUBLIC SUPPORT FOR THE GKR'S CURRENT ECONOMIC PROGRAM AND INDICATED THAT THE RECENT ECONOMIC REFORMS WERE NOT REALLY SUCCEEDING IN ACHIEVING ECONOMIC STABILITY BECAUSE THE ATTEMPTED REFORM OF THE EXCHANGE SYSTEM IS NOT BEING ACCOMPANIED BY BUDGETARY RESTRAINT. IN EFFECT, THE EXPECTED NET GAIN IN GOVERNMENT REVENUES THROUGH EXCHANGE RATE DEVALUATION

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AND THE HIGHER PRICES OF RICE AND POL, HAD BEEN MORE THAN OFFSET IN

THE SHORT-TERM (TWO MONTHS) BY THE RISE IN SALARIES. IN FACT, THE SALARY ADJUSTMENTS (WHICH BY SALARY ADVANCES TO CIVIL SERVANTS AND MILITARY FORCES AT THE END OF SEPTEMBER VIRTUALLY DOUBLES THEIR SALARIES FOR THAT MONTH) RELEASED LARGE SUME OF RIELS AND MIGHT HAVE CONTRIBUTED TO A RECENT SURGE IN THE BLACK MARKET RATE. HOWEVER, HE CONCEDED THAT THE SURGE MAY HAVE BEEN A CONSEQUENCE OF THE RECENT INCREASE IN THE WORLD PRICE OF GOLD OR SOME OTHER FACTOR, PARTICULARLY SINCE THE SALARY INCREASES OCCURRED IN LATE SEPTEMBER, WHEREAS THE BLACK MARKET SURGE WAS AN EARLY NOVEMBER PHENOMENON. (COMMENT: THE NOVEMBER BLACK MARKET SURGE WAS, HOWEVER, CONSISTENT WITH THE RELEASE OF THE NOVEMBER PAYROLL.)

3. AS TO THE CURRENT BUDGET SITUATION, HE DESCRIBED IT AS QUOTE HORRENDOUS UNQUOTE. HE ESTIMATED THAT THERE WOULD BE A CY 1974 DEFICIT OF 100 BILLION RIELS BEFORE TAKING COUNTERPART CONTRIBUTIONS INTO ACCOUNT AND INCLUDING EXTRA-BUDGETARY EXPENDITURES UNLESS STEPS ARE TAKEN IMMEDIATELY TO CURB THE CURRENT PRACTICE OF ISSUING WHAT HE CALLED ADVANCE CHECKS. THESE ARE CHECKS WHICH ARE BEING WRITTEN AGAINST EXPECTED FUTURE REVENUE DEPOSITS AND WHICH THUS ARE NON-REDEEMABLE WITH CURRENT FUNDS. HE ESTIMATED THAT SOME 10 BILLION RIELS OF FUNDS HAVE BEEN SPENT TO DATE THROUGH THIS METHOD, BUT ARE NOT YET RECORDED AS BUDGETARY EXPENDITURES. IT IS THESE ADVANCES PLUS THE INCREASED EXTRA-BUDGETARY EXPENDITURES AND DECREASED CUSTOMS REVENUES (RESULTING FROM THE RECENT ELIMINATION OF IMPORT TAXES) THAT ARE CAUSING THE PRESENT PROBLEM. (COMMENT: WE ARE SKEPTICAL OF THIS EXPOSITION OF "ADVANCE CHECKS" AND WILL TAKE UP THE MATTER WITH APPROPRIATE OFFICIALS.) ON THE OTHER HAND, REVENUES FROM COUNTERPART HAVE BEEN DOWN IN THE PAST QUARTER DUE TO REDUCED LICENSING OF CIP AND ESF IMPORTS, AND THE DELAY IN PL 480 RICE IMPORTS. SUCH IMPORTS ARE NOW ACCELERATING AND WILL LIKELY ALLEVIATE THE FISCAL PROBLEM SOMEWHAT BY THE END OF THE YEAR; HOWEVER, THIS DOES NOT OBSCURE THE FACT THAT THERE IS A SERIOUS CASH SHORTFALL AT PRESENT WHICH IS BEING COMPOUNDED THROUGH IRRESPONSIBLE FISCAL MANAGEMENT.

4. IN ORDER TO FORESTALL A RECURRENCE OF THIS SITUATION IN CY 1975, MR. CARBRIER SUGGESTED THAT THE GKR DEVELOP A 6-MONTH BUDGET FOR THE FIRST HALF OF 1975 AND FURTHER THAT THE MINISTER OF FINANCE BE GIVEN EXCEPTIONAL POWERS TO MANAGE THE BUDGET ON A PROGRAM-ORIENTED, CASH BASIS, WITHOUT HIS HAVING TO OBTAIN LEGISLATIVE APPRO-

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VAL FOR EVERY MINOR MODIFICATION, AS IS THE CASE AT PRESENT. FURTHER, A GOAL SHOULD BE SET OF NO MONETARY CREATION COMING FROM THE PUBLIC SECTOR, MEANING THAT FISCAL EXPENDITURES NOT BE ALLOWED TO EXCEED FISCAL REVENUES, FROM DOMESTIC SOURCES AND COUNTERPART. IF BANK ADVANCES ARE ALLOWED, THEY SHOULD NOT EXCEED IN TOTAL THE AGGREGATE VALUE OF STERILIZED RIELS. IN SHORT, THE FISCAL SECTOR MUST BE HELD WITHIN THE CONSTRAINTS OF ALLOWABLE (NON-HYPER-INFLATIONARY) MONETARY EXPANSION. THE USAID DIRECTOR ACKNOWLEDGED THAT

MONETARY-FISCAL BALANCE IS IN FACT A GOAL BUT THE PROBLEM IS NOT SO MUCH SETTING SENSIBLE GOALS AS IT IS GETTING GKR ECONOMIC AND FINANCIAL OFFICIALS TO UNDERSTAND THE ABSOLUTE NECESSITY FOR FISCAL RESPONSIBILITY. TOO OFTEN IN CAMBODIA, POLITICAL IMPERATIVES HAVE OVERRIDDEN ECONOMIC NECESSITY TO THE LONG-TERM DETRIMENT OF THE KHMER ECONOMY. MR. CHABRIER ACKNOWLEDGED THE PROBLEM; INDICATED THAT HE RECOGNIZED COMPLETELY THE URGENT NEED FOR BETTER FISCAL MANAGEMENT; SUGGESTED THAT THE FIRST STEPS SHOULD BE A MORE DETAILED CLASSIFICATION OF PUBLIC SECTOR EXPENDITURES AND CLARIFICATION OF FISCAL POLICY OBJECTIVES; AND OFFERED TO SOLICIT IMF HELP IN SOLVING THESE PROBLEMS. SPECIFICALLY, HE SAID HE WOULD REQUEST THAT ASSISTANCE BE PROVIDED CAMBODIA FROM THE FISCAL MANAGEMENT SECTION OF THE IMG. THE USAID DIRECTOR SAID THAT SUCH ASSISTANCE WOULD BE BOTH WELCOME AND USEFUL.

5. ADDRESSING THE REVENUES SIDE OF THE BUDGETARY PROBLEM, MR. CHABRIER PROPOSED THAT TAXATION BE PEGGED TO AN INFLATION INDEXING SYSTEM, WHEREBY THE VALUE OF TAXES TO BE COLLECTED IN THE CURRENT YEAR WOULD BE THE SUM OF THE PREVIOUS YEAR'S TAXES PLUS A PERCENTAGE INCREASE EQUIVALENT TO THE APPLICABLE ANNUAL RATE OF INFLATION. HE SAID THAT THE IMF TEAM HAD BEEN TOLD OF SEVERAL INSTANCES WHERE THE RATE OF TAXATION WAS UNREALISTICALLY LOW BECAUSE ALLOWANCES FOR INFLATION WERE NOT INCLUDED IN THE CALCULATIONS. THE NET EFFECT OF THIS PROCEDURE IS A TRANSFER OF INCOME FROM LOW EARNING SEGMENTS OF THE POPULATION TO HIGH INCOME EARNERS, A TREND ALL TOO PREVALENT IN THE PAST FOUR YEARS AND ONE THAT NEEDS TO BE REVERSED SHORTLY. A SECOND NEEDED STEP IS TO PUT PUBLIC ENTERPRISES ON A SELF-FINANCING BASIS. THIS WOULD LIKELY RESULT IN INCREASED CHARGES FOR POSTAL SERVICES, ELECTRICITY AND GAS, BUT THE CURRENT OPERATING DEFICITS EXPERIENCED BY THESE UTILITIES ARE ERODING THE FINANCIAL POSITION OF THE GOVERNMENT.

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P R 160550Z NOV 74  
FM AMEMBASSY PHNOM PENH  
TO SECSTATE WASHDC PRIORITY 8315  
INFO AMEMBASSY TOKYO

C O N F I D E N T I A L SECTION 2 OF 2 PHNOM PENH 15335

6. WHEREAS THE IMF TEAM SEES THE NEED FOR A DRASTIC OVERHAUL OF FISCAL PRACTICES AS INDICATED ABOVE, LESS DRAMATIC BUT NEVERTHELESS ESSENTIAL REFINEMENTS IN THE MONETARY SECTOR ARE ALSO NEEDED. FOR THE MOST PART, SUCH RECOMMENDED CHANGES WILL BE FORTHCOMING FROM MR. DUVSHANI, THE ISRAELI EXCHANGE RATE EXPERT CURRENTLY IN COUNTRY, BUT THE GENERAL DIRECTION SHOULD BE MOVEMENT TOWARDS A SINGLE RATE, AND LESS ATTENTION TO BLACK MARKET ACTIVITIES. FOR ONE, THE BLACK MARKET IS IN REALITY A VERY NARROW ONE AND PRONE TO VERY ERRATIC MOVEMENT ; THEREFORE WAYS SHOULD BE FOUND TO DEFUSE THE IMPACT IT PRESENTLY HAS ON PRICE TRENDS AND POLITICAL BEHAVIOR IN CAMBODIA. SECONDLY, THE PRESENT MULTIPLE RATE SYSTEM IS TERRIBLY CONFUSING TO THE AVERAGE KHMER ENTREPRENEUR AND HAS IN FACT INDUCED INORDINATE INTRA-MARKET SHIFTS. FOR EXAMPLE, RECENTLY THE N.M.C. HAS BEEN UNDER VERY HEAVY PRESSURE BECAUSE IT HAS THE COMBINED FEATURES OF AVAILABLE FX WHICH THE MARCHE LIBRE DOESN'T, PLUS LESS BURDENSOME ELIGIBILITY REQUIREMENTS THAN THE C.I.F. THE MULTIPLE MARKETS AND MULTIPLICITY OF RATES HAVE LED TO A CONFUSING SET OF EXCHANGE POLICIES AND PLACED UNDUE STRESS ON EXCHANGE RATES AS EQUILIBRATING INSTRUMENTS. ACCORDINGLY, THE PRESENT SYSTEM

SHOULD BE SUBSTITUTED BY ONE WHICH AIMS AT A TARGET RATE OF EXCH-  
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ANGE WITHIN A GIVEN TIME FRAME, AND CONSTANT INTERPLAY BETWEEN THE PERCEIVED DEMAND FOR FX AND PROJECTED AVAILABILITIES. A SIMPLIFIED RATE STRUCTURE WOULD NOT ONLY CLARIFY FX DEMAND-SUPPLY RELATIONSHIPS; IT WOULD ALSO EASE THE BURDEN PRESENTLY PLACED ON EXCHANGE RATE POLICIES AS ALMOST THE SOLE INSTRUMENT FOR OFFSETTING FISCAL MISMANAGEMENT THROUGH RIEL DEPRECIATION. FISCAL RATHER THAN MONETARY INSTRUMENTS SHOULD BE USED TO REMEDY FISCAL ABUSES.

7. IN ADDITION TO THE STEPS OUTLINED IN PARA 4 ABOVE FOR CURBING FISCAL EXCESSES, MR. CHABRIER SUGGESTED THAT OUTER LIMIT EXPENDITURE TARGETS FOR THE FIRST HALF OF CY 1975 BE ESTABLISHED BY KEY BUDGET SECTOR AS FOLLOWS:

|                       |                   |
|-----------------------|-------------------|
| BUDGET PROPER         | 75 BILLION RIELS  |
| REFUGEE PROGRAM       | 20 BILLION RIELS  |
| DOMESTIC RICE SUBSIDY | 10 BILLION RIELS  |
| OTHER                 | 5 BILLION RIELS   |
| TOTAL                 | 110 BILLION RIELS |

THE ABOVE SHOULD BE ADJUSTED AS REQUIRED WHEN A BETTER FIX ON

BUDGET REVENUE AVAILABILITY FROM DOMESTIC SOURCES AND COUNTERPART HAS BEEN OBTAINED.

8. WHILE IT CAME TOWARDS THE END OF THE SERIES OF ITEMS DISCUSSED WITH MR. CHABRIER AND THE IMF TEAM, THE IMPENDING PROBLEM OF AN ONEROUS FOREIGN DEBT SERVICE BURDEN LOOMS AS A MAJOR PROBLEM IN THE NEXT YEAR OR TWO. AS RECKONED BY THE IMF TEAM, FOREIGN DEBT WOULD REACH ROUGHLY 17.1 MILLION DOLLARS BY MID-1975. AN APPROXIMATE BREAKDOWN FOLLOWS:

|   |                |
|---|----------------|
| BILATERAL DEBT (W. GERMANY, FRANCE, ETC.) | \$4.0 MILLION  |
| PL 480 INTEREST                           | 32.0 MILLION   |
| SDR RECONSTITUTION                        | \$4.5 MILLION  |
| GOLD TRANCHE REPAYMENT                    | \$3.6 MILLION  |
| REFINANCING COMPENSATORY FINANCING        | \$2.3 MILLION  |
| OTHER                                     | 1.0 MILLION    |
| TOTAL                                     | \$17.1 MILLION |

9. IN RESPONSE TO A QUERY AS TO WHAT RANGE OF INTEREST RATE INCREASES FOR ONE YEAR DEPOSITS WOULD BE APPROPRIATE TO ATTRACT FURTHER DEPOSITS IN THE FORTHCOMING YEAR, MR. CHABRIER REPLIED THAT THEY SHOULD BE HIGHEST POLITICALLY FEASIBLE, WHICH IN CY 1975 IN HIS VIEW WOULD BE SOMETHING AROUND 48-50 PERCENT PER ANNUM. THIS WOULD BE A 2.5 TIMES INCREASE OVER THE PRESENT 20 PERCENT  
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RATE FOR ONE YEAR TIME DEPOSITS. HE ADDED, HOWEVER, THAT GKR FINANCIAL AND BANKING OFFICIALS WOULD WANT TO PROCEED TOWARDS THIS GOAL IN SMALL INCREMENTAL STEPS RATHER THAN IN ONE JUMP. OF COURSE, IF THE EXCHANGE RATE ADJUSTMENT EXPERIENCE GIVES ANY INDICATION, THE INCREMENTAL ROUTE TO HIGHER INTERST RATES IS PROBABLY FOREDOOMED.

10. COMMENT: IN GENERAL WE AGREE WITH THE IMF ASSESSMENT, AND PARTICULARLY WITH THEIR VIEW THAT THE RECENT ECONOMIC REFORMS WILL HAVE ALL BEEN FOR NOUGHT UNLESS THE GKR COMMENCES BUDGETARY RESTRAINT.

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## Message Attributes

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